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Neil E. Harl
Iowa State University

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Robert P. Achenbach, Jr.
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Dr. Neil E. Harl, Esq.
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Charitable Gifts With Retained Life Estates Can Be Troublesome

-by Neil E. Harl*

In general, public policy favors charitable giving. Charitable gifts during life are generally eligible for an income tax deduction,[1] and a federal gift tax deduction[2] and charitable gifts passing at death of the donor are usually eligible for a federal estate tax deduction.[3] In addition there is a special provision for transfers of a personal residence or a farm to a charitable organization with a unique opportunity for a life estate to precede the charitable bequest or devise.[4] That opportunity does not exist for other types of property where no gift tax, estate tax or income tax deduction is allowed for the charitable gift if a non-charitable beneficiary precedes the charitable bequest or devise unless the transfer is in trust and meets the requirements to ne a charitable remainder annuity trust, unitrust or pooled income fund.[5]

However, clear as those provisions may seem, problems can arise especially with retained life estates preceding the charitable gift.

A life estate preceding the charitable bequest or devise

If a personal residence or farm is transferred to a charitable organization with a life estate for the transferor's spouse, and the interests vest at the time of the initial transaction, the remainder interest held by the charitable organization is deductible for income tax[6] and gift tax[7] purposes at that time. Moreover, at the death of the holder of the life estate (who was not an owner or co-owner of the property in question) nothing would be included in the individual's gross estate at death.[8]

What happens at the death of the holder of the life estate? Nothing is included in the estate of the deceased holder of the life estate.

A *retained* life estate (or life estates) preceding the charitable bequest or devise

But what if the life estate was a *retained* life estate where the owner of the residence (or farm) held the life estate? In that case, the *fair market value of the property at the time of death is included in the gross estate of the deceased holder of the retained life estate*.[9] This can be a substantial jolt if the property has increased in value after the time when the transaction to give the residence or farm to a charitable organization was finalized. Remember, this provision is available for farms as well as residences and farmland values have increased sharply in recent years, as much as 10 fold increases over the past 25 to 30 years.[10] For a farm or personal residence, the full benefit from the property is assured for the holder of the retained life estate for the duration of the life estate (until death occurs).

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* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

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Solutions largely bypass farms and residences

This outcome (inclusion of the fair market value in the gross estate at the death of the holder of the retained life estate) does not occur if the remainder interest is held by a charitable remainder annuity trust, unitrust or pooled income fund (which is unlikely for farmland and not often used with a residence)and is little help in most instances or, in the case of any other interest, it is in the form of a guaranteed amount as a fixed percentage distributed yearly of the fair market value of the property which is likely not a solution.[11] Neither is likely for a retained interest in a residence where occupancy is usually the "income" or for farmland where the farmland is rented under a crop share or livestock share lease or even a cash rent lease where the rental payment is not based on the "fair market value" of the property.

The statutory treatment[12] of charitable bequests or devises with a retained life estate by the property owner is confirmed by the regulations.[13] Those regulations state that a gift of a residence to a charitable organization with a life estate to the owner's wife does not result in the inclusion in the donor's estate at death at the date of death value.[14] Likewise, a life estate to a daughter of the donor of farmland for a gift to a charitable organization does not result in inclusion in the donor's estate at the date of death value, either.[15] It is only where the donor has a retained life estate that inclusion in the gross estate is required at the donor's death at its date of death value.[16]

Uncertainty of income passing to the holder of the retained life estate

But what if there is uncertainty as to what was to be received by the holder of the retained life estate? Regulations under I.R.C. § 2036[11] govern the handling of that situation. In an example in the regulations, the holder of the retained life estate was to receive quarterly payments of six percent of the fair market value of a trust. At the termination of the trust arrangement, the then-remaining corpus and any accrued income was to be distributed to the charitable organization. However, at the death of the holder of the retained life estate, the calculations showed that the holder of the retained life estate had actually received over the course of the trust more than the full amount that is statutorily required which meant that the full fair market value was included in the gross estate. Had the amount received been less than the statutory requirement, there would have been additional value passing to the charitable organization which would support a further charitable deduction. Note that this does not apply to vested interests where the statutory requirements are automatically met as is the case where the holder of the retained life estate is holding an interest in a farm or personal residence.[12]

Where there is no life estate, retained or otherwise

If there is no life estate involved, the fair market value at death of the property owner is in line for a charitable deduction if the property passes to a charitable organization at that time.[13]

So is a retained life estate a good idea?

In a period of rising property values (and the long-term trend is upward for most property values) the requirement that the fair market value must be included in the gross estate where a retained life estate held by the donor is involved is clearly disadvantageous. The transaction usually provides that the donor give up title to the property to the charitable organization and the donor does not benefit from the increase in property value thereafter. Yet the required inclusion in the gross estate of the property's fair market value at death means the increased property value is not available to defray the tax.

Careful planning is needed

What this suggests is that careful planning is needed to avoid unexpected tax consequences at death, paying particular attention to retained life estates.

ENDNOTES

[1] I.R.C. § 170(a)(1).

[2] I.R.C. § 2522.

[3] I.R.C. § 2055.

[4] I.R.C. § 170(f)(3)(B).

[5] I.R.C. §§ 170(f)(3)(B), 2055(e)(2). See Burdick v. Comm'r, 979 F.2d 1369 (9th Cir. 1992) (estate not entitled to deduct direct payment to charity in outright settlement of remainder interest in non-deductible split-interest trust).

[6] I.R.C. §§ 170(a)(1), 170(f)(3)(B)(i).

[7] I.R.C. § 2522.

[8] *Cf.* I.R.C. § 2036(a)(1).

[9] I.R.C. § 2036(a)(1). See Treas. Reg. § 20.2036-1(c)(1)(i).

[10] See Duffy,"Iowa Land Value Survey," Iowa State University, December 2014.

[11] I.R.C. § 2055(e)(2).

[12] *Id.*

[13] Treas. Reg. § 20.2055-2(e)(2).

[14] Treas. Reg. § 20.2055-2(e)(2)(ii).

[15] Treas. Reg. § 20.2055-2(e)(2)(iii).

[16] See I.R.C. § 2036(a).

[17] Treas. Reg. § 20.2036-1(c)(2)(ii).

[18] Treas. Reg. § 20.2036-1(c)(2)(i).

[19] I.R.C. § 2055(d), (e).